SOLUTION: AUDIT & INTERNAL REVIEW MAY 2008

QUESTION 1

a) Most readers of financial statements believe that auditors are ultimately responsible for the financial statements or at least that they have a responsibility to detect all errors, fraud and illegal acts. This is simply not true.

The financial statements are the responsibility of management; the auditor's responsibility is to express an opinion on the financial statements.

Management is to take explicit responsibility for their company's financial statements by "certifying" among other things, that they are responsible for establishing and maintaining internal control, and that the financial statements fairly present the entity's financial conditions and operations.

The Auditing Standards provides that the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected. The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatement whether caused by errors or fraud that are not material to the financial statements will be detected.

b) Materiality is not capable of general mathematical definition as it has both qualitative and quantitative aspects. Materiality considerations may differ depending on the aspect of the financial statement being considered. It is considered at both the overall financial statement level and in relation to individual accounts balance, classes of transactions and disclosures. In assessing materiality the auditor must consider the following:

- compare the magnitude of the item with the overall view presented by the accounts
- compare the magnitude of the item with the magnitude of the same item in the previous year
- compare the magnitude of the item with the total of which it forms a part. For example debtors may include an employee's loan but if employee's loan becomes large thus material, then the description 'debtors' would be inadequate
- consider the presentation and disclosure of the item
- consider statutory issues.

QUESTION 2

a) The audit objectives in verification of tangible fixed assets include to determine whether:

(i) The cost or other basis of recording fixed assets is appropriate and has been consistently applied.

(ii) Items have been properly classified between capital and revenue expenditure.

(iii) Additions and disposals of fixed assets are valid and appropriately recorded.

(iv) The fixed assets recorded in the accounts exist and the client has a valid title.

(v) Adequate provision for permanent diminution in value has been made.

(vi) Fixed assets pledged as security are identified.

(vii) The accounting disclosure requirements have been complied with.

b) The factors which would reduce the control risk associated with fixed assets include:

(i) The use of capital budgeting for the acquisition of fixed assets together with careful monitoring and follow up procedures.

(ii) The use of identification tags in prenumbered order attached to assets reconciled regularly to the fixed assets register.

(iii) The use of detailed fixed assets register which are regularly reconciled to the financial records.

(iv) A formal policy for capitalization of purchased amounts, depreciation and disposals of fixed assets.

(v) Adequate physical safe guarding and securing of fixed assets.

c) Audit procedures on legal claims include:

- Review of the client's systems for recording claims and procedure for bringing this to the attention of the management or the board.
- Discussion of arrangement by management for instructing solicitors and this will be done with the officers responsible for legal matters.
- Examine board minutes or minutes of executive and other important committees for reference to indicators for possible claims.
- Examine bills rendered by solicitors and correspondence with them in which connections the solicitors are requested to furnish bills or estimates of charges to date or to confirm that they have no unbilled charges.
- Obtain a list of matters referred to solicitors from appropriate directors or management with estimate of possible outcome of possible liabilities.
- Obtain a written representation or assurance from the appropriate director or official that he is not aware of any matter referred to solicitors other than those already disclosed.
- Obtain written representation or confirmation from third parties concerning the representations made by management or the board of directors.
- Evaluate all the above and their impact on applicability of going concern of the company.
- Confirm that the impact of the legal claims is fully disclosed in the financial statements.

QUESTION 3

a) The main stages of a system based audit are:

- Determine audit approach or planning the audit.

- • The first thing in any audit is to determine its scope and the auditor's general approach. For statutory audit the scope is clearly laid down in the company's code.

  A letter of engagement setting out the terms of audit will be submitted or confirmed before the start of each audit.

- • In addition to the letter of engagement, auditors should prepare an audit plan to be placed on the audit file.

- Ascertain the accounting and internal control system. The objective of this stage is to determine the flow of document and the extent of control in existence.

  The objective here is also to have or prepare a comprehensive record for use in evaluation of the system.

- Confirmation of the system recorded. The auditors may confirm their understanding of the system by performing work through test.

- Assess the accounting and internal control (Evaluation test). The purpose of evaluating the system is to assess their reliability and formulate bases for testing their effectiveness in practice.

- Test the accounting system and internal control. The objective is to test compliance to controls in practice.

- Sending interim report.

- Test the final statements.

- Review the financial statements.

- Express an opinion.

b) (i) The importance of management representation as audit evidence are:

- It contains the client's management responsibilities for complete and accurate financial statement.

- It also serves the purpose of providing audit evidence particularly in areas where normal audit procedures cannot be applied.

- The auditor may need evidence to produce to a court that the directors are aware of their responsibilities.

- It serves as a documented representation from management as part of auditors working papers.

(ii) The factors to be considered in deciding the quality of audit evidence are:

- Independence and qualification of the provider ie evidence from independent sources outside the company, increase reliability, also evidence from banks or solicitors or other knowledgeable sources is reliable.

- Quality of clients internal control structure – the more effective design control structures the higher the reliability of the obtained evidence.

- Direct acquisition of knowledge by the auditor – evidence which the auditor acquires by computation is reliable because such acquisition involves no possible interference from the client or the third party.

QUESTION 4

a) (i) Completeness

(ii) Existence

(iii) Valuation

(iv) Ownership

(v) Existence

b) The audit work to perform when verifying disposal of a fixed asset are:

- Verify disposal with supporting documentation, checking transfer of title, sales price and date of completion and payment.
- Check calculation of profit or loss
- Check that disposals have been authorized.
- Consider whether proceeds are reasonable.
- Ensure that the cost and accumulated depreciation on assets disposed has been removed from the books.
- If the property was used as security, ensure release from security had been correctly made.
- Ensure that proper presentation and disclosure has been made in the financial statement.

c) The uses that auditors can make of computers are:

- Provide automated working papers which are automatically cross referenced and balanced. Whenever a figure is adjusted, the computer will also update all the relevant papers.
- Calculating sample sizes and selecting items to be tested.
- Carrying out analytical calculation and highlighting items where there have been significant movements.
- Carrying out automated checks on files-house-keeping points such as dating, signature and audit conclusion.
- Producing time budgets and comparing actual hours with budgets.
- Word processing of audit programmes which can be updated from year to year.
- Maintaining permanent file information and making such information readily accessible to the auditor.

- In addition, other processes can be automated such as account preparation and production and client billing procedures.
- Computers can be used to process audit reports.

QUESTION 5

(a) The procedures should include:

(i) Review of previous year's audit files for matters which will be relevant in the current year.

(ii) Consider the effect of any change in legislation or accounting practices.

(iii) Meet with the client to discuss any significant changes in the client's accounting systems and consider their effect on the audit approach and time needed for the audit.

(iv) Obtain and review copies of management accounts.

(v) Discuss with the client the timing of both interim and year end visits.

(vi) Decide the audit approach and draft a memorandum outlining it to be approved by the audit partner.

(vii) Decide the number and grade of staff required for the audit and ensure that appropriate people will be available at the agreed dates/time.

(viii) Prepare detailed time and cost budgets.

(ix) Inform the client in writing of the dates planned for audit visits and of the names of the staff involved.

(x) Brief the audit team on the client and on their responsibilities.

(b) (i) Risk-based audit is used by auditors in order to concentrate on high risk clients and on high risk areas of a client's business rather than perform detailed audit tests on all areas of client's business. It enables a cost effective audit to be achieved.

(ii) Inherent risk: Is the susceptibility of account balance or class of transactions to material misstatement, irrespective of related internal controls. This risk will be affected by such items as how much the company is subject to market forces, the cost situation of the company, its trading history, etc. Inventory for example is more inherently risky than cash as there is greater scope for manipulation and error. Inherent risk is usually assessed at both the financial statement level and at the level of individual balances and transactions.

(iii) Audit software: This comprises computer programs used by the auditor to examine an enterprise's computer files. It may consist of generalized package programs, purpose-written programs or utility programs used by the client.

Typical uses of such programs include: calculation checks, detecting violation of systems rules, detecting unreasonable items, conducting calculations and analysis, etc.